United States Senate Budget Committee
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Spending Cuts And Economic Growth: What Does The Cross-Country Empirical Evidence Show?

U.S. Senate Budget Committee Republican staff analysis, May 12, 2011

Introduction

The federal debt held by the public has doubled, in nominal terms, in less than four years. It now stands at over 62 percent of GDP, the highest level since 1951. What costs does this place on our economy? With our fragile economy still suffering high unemployment, can we risk attempting to slow the accumulation of more debt by reducing government spending? This paper examines these questions by surveying the available literature and empirical evidence regarding the economic effects of government debt and spending reductions on economic growth.

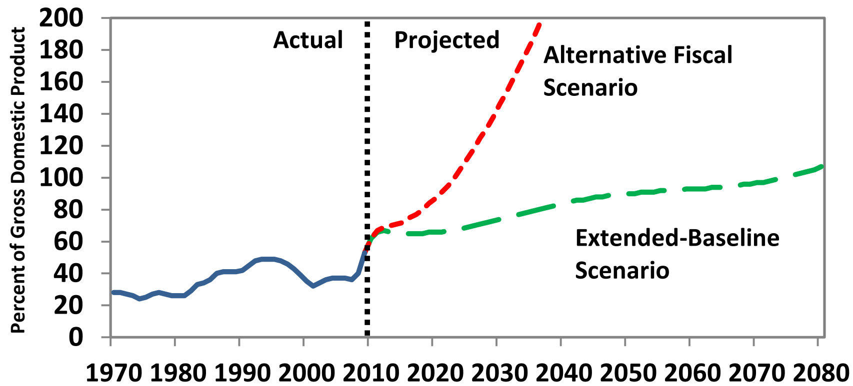
The available evidence shows that:

1) a national debt crisis could result in economic collapse;
2) our high national debt already imposes sustained economic costs;
3) our growing debt can be slowed by immediate reductions in government spending;
4) reductions in federal spending, as part of successful fiscal consolidations, have demonstrably led to economic growth
5) fiscal consolidations focused on spending cuts are far more successful than those relying on tax increases and those that evenly combine tax increases and spending cuts.

U.S. Debt: Warnings And An Impending Fiscal Crisis

The Congressional Budget Office's "current law baseline projections" show federal debt held by the public rising from 69 percent of GDP at the end of this year to 76 percent of GDP by the end of 2021.[1] Under a more plausible scenario that assumes Congress will enact laws that maintain existing tax cuts and payments to doctors, CBO estimates that debt held by the public in 2021 would rise to almost 100 percent of GDP, the highest level since the war-induced high in 1946. Debt held by the public grows so fast that by 2037 it is over two-times projected GDP and over nine-times GDP by the 2080s—see Figure 1. These projections illustrate unsustainability; no country, even the U.S., could obtain credit at such high levels of debt.

FIGURE 1:
Federal Debt Held by the Public Under CBO's Long-Term Budget Scenarios



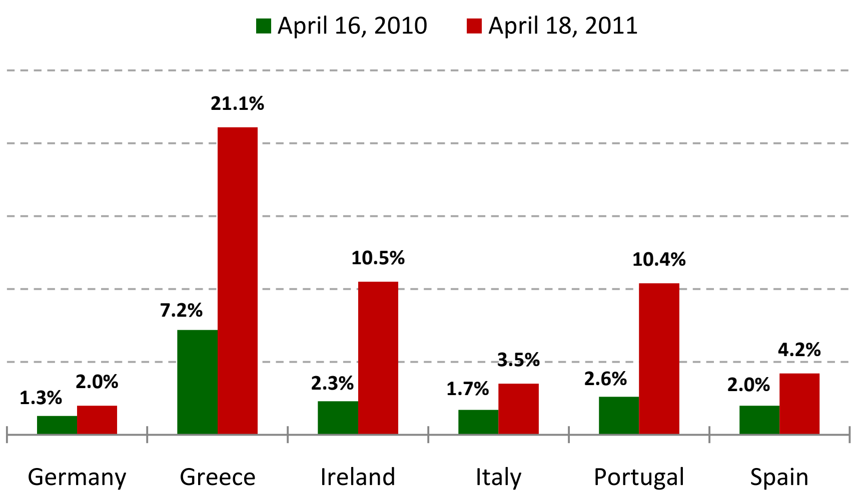
Source: Senate Budget Committee Republican Staff, Congresional Budget Office
NOTE: Includes recently enacted health care legislation.

As deficits and debt have grown extraordinarily, so too have warnings that our unsustainable fiscal path will lead to crisis. Recent experiences of Greece and other fiscally challenged Eurozone countries have made clear that a fiscal crisis involves painful and precipitous increases in interest

[1] GDP—gross domestic product—is a broad measure of the value of goods and services produced in the economy.

rates. Rates rise as sovereign debt investors demand greater compensation for growing perceived default risks. This has become the reality for a number of European countries with unsustainable indebtedness—see Figure 2.

FIGURE 2 **3-Year Government Bonds (Yields, %)**



Source: Bloomberg

The cost of issuing three-year debt for Greece has roughly tripled over a one-year period and the cost for Ireland and Portugal has risen roughly fourfold.

The rapid and sudden increases in funding costs force sudden and painful choices, as previously profligate governments are forced to scale back social benefit promises and the size of government workforces. Those who counted on the promises are disappointed; disappointment fuels unrest.

What would a large increase in funding cost mean to the U.S.? CBO, in a recent analysis of alternative interest rate scenarios, estimates that if the 10-year Treasury rate were to rise from an average of 3.8 percent in 2011 to around the average levels of over 10 percent during the high-rate period of 1981-1990, then deficits would rise by over $12 *trillion* between 2012 and 2021. Debt held by the public under such a scenario would rise by over $23 *trillion* by 2021.[2] Deficits and debt of those magnitudes would choke off private investment as the government absorbs ever increasing amounts of resources from markets, pricing out and crowding out private productive investment spending. The ensuing economic downfall would likely lead to a precipitous financial crisis.

Recent experiences in financial markets demonstrate that shifts in market sentiments and asset prices can occur quickly and be executed, through automatic electronic orders, even faster. According to the recent Financial Crisis Inquiry Report (2011), quoting Federal Reserve (Fed) Chairman Ben Bernanke concerning the speed of the crisis: "… out of maybe the 13, 13 of the most important

[2] Congressional Budget Office, *Analysis of the Effects of Three Interest Rate Scenarios on the Federal Budget Deficit: Letter to the Honorable Paul Ryan* (February 24, 2011), available at http://www.cbo.gov/ftpdocs/120xx/doc12081/Ryan_Letter_Interest_Rates_2-24-2011.pdf.

financial institutions in the United States, 12 were at risk of failure within a period of a week or two."[3]

Given the level of debt that the U.S. has accumulated, the nation faces a growing risk of sudden reversal of sentiment in the global market for its debt. Any sudden loss of confidence can, with bank-run rapidity, lead to spikes in interest rates that would choke off economic activity and any chance for sustained economic recovery.

What might a debt crisis mean for the United States? CBO paints the following picture:

> In a fiscal crisis, investors would lose confidence in the government's ability to manage its budget, and the government would thereby lose its ability to borrow at affordable rates. It is possible that interest rates would rise gradually as investors' confidence declined, giving legislators advance warning of the worsening situation and sufficient time to make policy choices that could avert a crisis. But as other countries' experiences show, it is also possible that investors would lose confidence abruptly and interest rates on government debt would rise sharply. The exact point at which such a crisis might occur for the United States is unknown, in part because the ratio of federal debt to GDP is climbing into unfamiliar territory.
>
> If the United States encountered a fiscal crisis, the abrupt rise in interest rates would reflect investors' fears that the government would renege on the terms of its existing debt or that it would increase the supply of money to finance its activities or pay creditors and thereby boost inflation. To restore investors' confidence, policymakers would probably need to enact spending cuts or tax increases more drastic and painful than those that would have been necessary had the adjustments come sooner. [4]

Unfortunately, the number and frequency of warnings about a U.S. debt crisis from reputable sources indicates we are approaching the edge of this cliff:

- Credit-rating agency Standard & Poor's issued a downgrade in its outlook on U.S. debt on April 18, 2011—the first downgrade since the firm began rating U.S. debt in 1941—and warned that "…we believe there is at least a one-in-three likelihood that we could lower our long-term rating on the U.S. within two years";[5]
- Credit-rating agencies Moody's Investor Services and Standard & Poor's warned of potential loss of triple-A rating status for U.S. government debt as recently as January 2011; [6]
- Fed Chairman Bernanke, in February 2011, called our fiscal path unsustainable and warned of "… a rapid and painful response to a looming or actual fiscal crisis";[7]

[3] Financial Crisis Inquiry Commission (2011), *The Financial Crisis Inquiry Report*, U.S. Government Printing Office; Washington, DC, page 354, available at http://www.gpoaccess.gov/fcic/fcic.pdf.

[4] Congressional Budget Office, *Federal Debt and the Risk of a Fiscal Crisis* (July 27, 2010), available at http://www.cbo.gov/ftpdocs/116xx/doc11659/07-27_Debt_FiscalCrisis_Brief.pdf.

[5] Standard & Poor's, *Research Update: United States of America 'AAA/A-1+' Rating Affirmed; Outlook Revised to Negative*, April 18, 2011.

[6] See, for example, the January 14 report in the Wall Street Journal, available at http://online.wsj.com/article/SB1000 1424052748703583404576079311379009904.html.

[7] See Chairman Bernanke's February 3, 2011 speech at http://www.federalreserve.gov/newsevents/speech/bernanke

- Former Fed Chairman Greenspan, in January 2011, questioned when the U.S. would act boldly on the budget, said that "[t]he only question is, will it be before or after the bond-market crisis";[8]
- Admiral Mike Mullen, Chairman of the Joint Chiefs of Staff, said in July 2010 that: "…the biggest threat we have to our national security is our debt";[9]
- Erskine Bowles—President Clinton's White House Chief of Staff and Co-Chairman of President Obama's fiscal commission—testified in March 2011 that the U.S. faces "the most predictable economic crisis in history" if it fails to alter its unsustainable fiscal path;[10]
- Secretary of State Clinton, in September 2010, indicated that rising debt in the U.S. poses "a national security threat" and "sends a message of weakness internationally";[11]
- Peter Orszag, President Obama's former budget chief, suggested in January 2011 that a U.S. "home-grown fiscal crisis" would derail the economy;[12]
- 10 former chairs of the Council of Economic Advisors, who served in Republican and Democratic administrations, wrote in March 2011 that "At some point, bond markets are likely to turn on the United States—leading to a crisis that could dwarf 2008";[13]
- Bill Gross, who manages over $230 billion in the world's largest bond fund at Pacific Investment Management Co. (PIMCO), announced in March 2011 that he had dumped all long-term Treasuries from his fund, anticipating "higher yields and lower prices."[14]

These numerous debt-crisis warnings indicate a growing consensus that we are at or near a debt-to-GDP threshold which, if crossed, would mean significantly slower growth. The warnings also indicate that the U.S. cannot assume that gradual reductions in deficits and debt will be viewed by creditors as a credible course to fiscal sustainability. Recent experiences of many countries, such as those in Figure 2 above, indicate that interest-rate effects of additional debt accumulation can be highly non-linear—low interest rates of today can spike up precipitously, rapidly choking off economic activity and job creation. Avoiding such a fate means confronting fiscal challenges today through spending reductions, tax hikes, or both.

Consideration of cuts in government spending raises questions. Do spending cuts threaten the economic recovery, as simple Keynesian reasoning would suggest? Have there been fiscal policy changes involving significant reductions in government spending that have proven successful in bringing a country out of a fiscal crisis without harm to its economy?

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[8] See, for example, the January 8, 2011 report in the Wall Street Journal, available at http://online.wsj.com/article/SB 10001424052748704739504576067832461529192.html.

[9] See, for example, the report available at http://www.npr.org/templates/story/story.php?storyId=128320487.

[10] See Congressional testimony before the Senate Budget Committee on March 8, 2011 available at http://www.senate.gov/fplayers/CommPlayer/commFlashPlayer.cfm?fn=budget030811&st=1200.

[11] See transcript of "A Conversation with U.S. Secretary of State Hillary Rodham Clinton," at the Council on Foreign Relations available at http://www.cfr.org/diplomacy/conversation-us-secretary-state-hillary-rodham-clinton/p22896.

[12] See op-ed in the Financial Times on January 20, 2011 available at http://cachef.ft.com/cms/s/0/10612eec-24cc-11e0-a919-00144feab49a.html#axzz1I5WhH3P9.

[13] See the March 24, 2011 letter of the chairs, available at http://www.politico.com/news/stories/0311/51864.html.

[14] See the March 2011 PIMCO newsletter, available at http://investments.pimco.com/MarketingPrograms/External%20Documents/PIMCO_BG_QA_Capturing_Opportunity_in_the_Global_Bond_Market.pdf.

For answers to these and related questions, it is instructive to draw on a large and expanding body of research on experiences of fiscally challenged countries that implemented policies aimed at significantly reducing government deficits and debt—typically called "fiscal consolidations."

The Economic Costs Of Our Current Debt

Recent economic studies have found support for non-linear impacts of debt on economic growth, with adverse effects occurring especially after a certain debt-to-GDP ratio threshold has been crossed.[15] Research by Carmen Reinhart of the University of Maryland and Kenneth Rogoff of Harvard University finds that countries with a gross public debt exceeding around 90 percent of annual economic output tended to grow significantly slower than countries with debt-to-GDP ratios below that threshold. Specifically, for advanced countries above the 90 percent threshold, average annual growth was about two percentage points lower than for countries with public debt less than 30 percent of output. U.S. gross public debt was already 93 percent of GDP at the end of fiscal year 2010, a level not seen since immediately after World War II. The US gross public debt is expected to reach 102.6 percent of GDP by the end of 2011, well above the 90 percent level.

A number of effects cause a large national debt to suppress economic activity. These include:

- the expanding federal need for cash crowds out opportunities for private investment;
- large and increasing interest payments on the federal debt reduces funding for desirable government programs, such as those that help the poor and/or promote economic growth, including education and infrastructure;
- reducing the flexibility of policymakers in the future to respond to unexpected challenges, such as another economic downturn or an international crisis; and
- diminished private investment and economic growth, and less stable revenues, should the Federal Government raise taxes.

Each of these is discussed in further detail below.

Crowding Out—With continued deficits and growing debt, more and more national savings go to servicing government debt rather than to investment in productive private capital goods such as factories, machines, and other such incubators of private job creation. That is, government spending "crowds out" private investment spending, leading to lower output and incomes and fewer jobs than would occur without a growing government.

Some commentators, such as economist Paul Krugman, contend that government spending does not crowd out private spending in the current near-zero short-term interest rate environment. With interest rates as low as they are today, the argument goes, the traditional avenue of crowding out is not

[15] Included among such studies is Carmen M. Reinhart and Kenneth S. Rogoff, *Growth in a Time of Debt*, working paper (Harvard University, January 7, 2010) available at http://www.economics.harvard.edu/files/faculty/51_Growth_in_Time_Debt.pdf. and the studies reviewed in Cristina Checherita and Philipp Rother, *The Impact of High and Growing Government Debt on Economic Growth: An Empirical Investigation for the Euro Area*, European Central Bank Working Paper No. 1237 (European Central Bank, August 2010) available at http://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1237.pdf.

operative. That traditional avenue is where government competes for resources in financial markets with the private sector, driving up interest rates and choking off private investment spending.

Short-term rates are indeed close to zero, for Treasury maturities of up to approximately one year. Those unusually low rates reflect the extraordinary intervention into financial markets by the Fed, and are not indicative of market-based supply and demand forces.

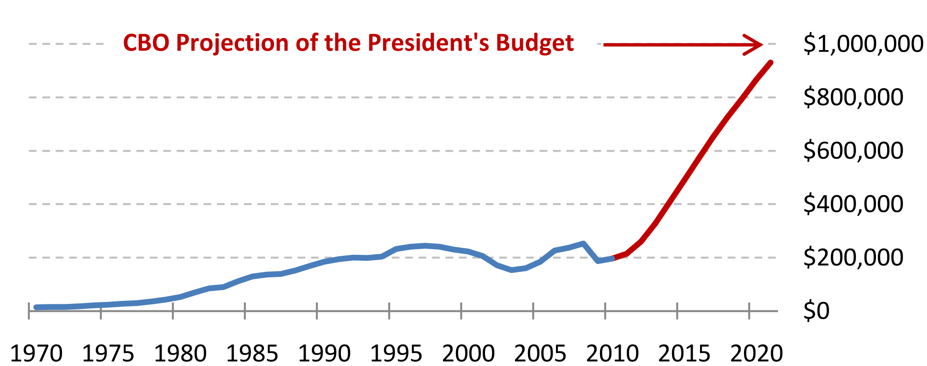
Yet, even with low short-term rates, longer-term interest rates are not zero and are influenced by supply and demand forces in markets for long-term funds. The 10-year Treasury rate has averaged around 3.5 percent since the beginning of the financial crisis in August 2007. In fact, it remains the case that outsized borrowing by the Federal Government has exerted upward pressure on longer-term interest rates. Government borrowing, by pushing long-term interest rates higher, chokes off some private, productive investment spending that would otherwise occur.

There remains further room for long-term interest rates to decline and stimulate private investment spending and the economy. Indeed, a major motivation for the Fed's recent purchases of well over $600 billion of longer-term Treasury securities is its intention to lower longer-term interest rates in order to stimulate interest-sensitive spending, such as home purchases by households or capital expenditures by manufacturing firms.

Thus, the Fed's actions provide additional evidence that crowding out is occurring and is leading to higher long-term interest rates than would be the case without elevated demands for resources by government. This means the nation's debt is leading to higher costs for businesses and American households to obtain long-term credit. Longer-term interest rates would be even lower today, and more stimulating of economic activity, if today's deficit and government debt were lower.

Pressure on Federal Programs—As deficits and debt continue to mount, the power of compound interest means an ever-increasing amount of federal resources are being devoted to interest payments to help pay for past deficit spending. As Figure 3 shows, interest payments are projected to increase nearly fivefold under the President's budget, to almost $1 *trillion* by 2021.

FIGURE 3 **Net Interest Payments (Billions)**



Source: Office of Management and Budget, Hisorical Tables.; CBO Estimate of the President's Budget, March 20011 for projections.

This means desirable federal programs will have to be cut, in increasingly painful amounts, so that the government will be less and less able to provide resources for everything from nutrition assistance to highway maintenance and construction. (Revenue could be increased to diminish these reductions; this option will be discussed below.) To the extent these programs improve the country's welfare and economic growth, they are already on a path to being squeezed.

Loss of Flexibility—As deficits continue and debt mounts, there will be fewer and fewer federal resources available to address unexpected events. Future borrowing at potentially crisis-induced elevated interest rates will make responses to future emergencies much more costly. It will become more difficult and expensive to cope with devastation from a natural disaster like a hurricane or an earthquake or to support unexpected military activities.

There is also potential for mountainous debt to restrict future flexibility in international relations. The U.S. has increasingly relied on foreign governments to finance its debt, providing foreign creditors greater potential financial leverage in international dialogue. As the Co-Chairman of President Obama's fiscal commission Erskine Bowles stated in testimony before the Senate Budget Committee in March 2011: "It's crazy. We have a treaty that says if China attacks Taiwan, we're supposed to defend Taiwan. But to do that we'd first have to borrow the money from China."[16]

Taxes—Apart from cutting federal spending, payments of interest and principal on mounting debt could be financed by increasing tax rates. This carries its own costs, however. According to the Congressional Budget Office, higher "rates will discourage work and savings and further reduce output."[17] Reduced output means lower incomes, less wealth, and fewer jobs. By relying on higher taxes to pay for higher debt and a larger government footprint, the U.S. runs the risk of catching "Eurosclerosis:" high and persistent unemployment that has plagued many European countries, such as France and Italy, for several decades.[18]

Higher taxes can lead to chronic unemployment because of the adverse incentives caused by higher marginal tax rates on labor and capital income.[19] A number of recent studies show that these additional costs can severely restrain economic performance. For instance, Nobel Prize laureate Edward Prescott found direct evidence that high taxes lead to lower living standards in many European countries. Over the last 40 years, in particular, fiscal policy in many European countries—with high taxes and an expansive government sector—was responsible for the large decline in hours worked. According to Prescott, "Americans now work 50 percent more than do Germans, French, and Italians. This was not the case in the early 1970s, when the Western Europeans worked more than Americans."[20]

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[16] The testimony can be viewed at http://www.senate.gov/fplayers/CommPlayer/commFlashPlayer.cfm?fn=budget030811&st=1200.

[17] See, for example, Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options* (March, 2011) available at http://www.cbo.gov/doc.cfm?index=12085.

[18] German economist Herbert Giersch reportedly coined the term Eurosclerosis in 1985 to describe European economies suffering from persistently high unemployment rates at a time of overall growth. See, for example, the Business Week article at http://www.businessweek.com/news/2010-07-07/no-eurosclerosis-for-u-s-bofa-s-schmieding-says-tom-keene.html.

[19] The marginal tax rate on activity refers to the amount of taxes that must be paid given an extra—or marginal—dollar of income or receipts derived from that activity.

[20] Edward Prescott, *Why Do Americans Work So Much More Than Europeans,* Quarterly Review, Vol. 28, No. 1 (Federal Reserve Bank of Minneapolis, July, 2004) available at http://www.minneapolisfed.org/research/QR/QR2811.pdf.

Investigating why work fell in European countries over several decades, Prescott points to high taxes on labor income. Those high taxes were used to fuel expanded government sectors. Incomes, wealth, and living standards suffered relative to the U.S., where taxes were lower and government accounted for a smaller piece of the economy.[21]

This is relevant to the United States because, given that the two largest sources of federal revenues—over 80 percent by CBO estimates—come from individual income taxes and social insurance taxes, tackling fiscal challenges through increased tax rates would likely involve higher taxes on labor.[22] This would lead us down the same road as these European countries.

Finally, increased taxes in the United States could likely be increasingly concentrated on the wealthy. As the states of California and New York have realized, however, concentrating a tax-revenue base on high income earners is precarious. For example, nearly half of California's income taxes prior to the recession came from the top 1% of income earners. Those incomes proved to be highly volatile, however, and fell by more than twice as much as the incomes of the rest of the population during the recession. The large decline in the income-tax base took California over a revenue cliff.[23]

The U.S. tax code is already very progressive: for example, the top 1 percent of taxpayers—those with wages and salaries, dividends, and capital gains above roughly $380,000—paid 38 percent of taxes according to the Internal Revenue Service's income tax statistics for 2008, the latest year of data availability. There is simply not enough revenue available to cover our recent deficits, even if tax policy confiscated all the taxable income of all the "millionaires and billionaires" in the country. Focusing our income tax base on high, and volatile, income earners will increase the cyclicality of our tax base and fiscal position.

Reducing Debt Through Spending Reductions

Immediate reductions in spending will begin a necessary move to reduce deficits and reduce the pace of debt accumulation. For example, a Budget Committee analysis found that a $61 billion reduction in spending in fiscal year 2011 would immediately begin to tackle our spending problem and would save $862 billion over the next 10 years. Cutting spending can successfully bring our country out of debt, while moving our economy back toward a system that rewards private productivity, ingenuity, and American workers. Spending reductions do not necessarily mean, as Keynesian reasoning dictates, that the economy suffers.

[21] See, for example, the discussion in the Federal Reserve Bank of Minneapolis *The Region* titled *European Vacation: Why Americans Work More Than Europeans* (December, 2003) available at http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=3346. The article identifies, for example, that while European countries like France, Italy, and Germany have capital endowments and productivity levels comparable to the U.S. "…differences in wealth are due almost exclusively to the markedly lower number of hours worked in these European countries."

[22] Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options* (March, 2011).

[23] See for example *The Price of Taxing the Rich* (The Wall Street Journal, March 26, 2011) available at http://online.wsj.com/article/SB10001424052748704604704576220491592684626.html.

Indeed, a consistent and striking conclusion from a large and growing body of evidence is that *successful* efforts to climb out of debt are composed mostly of spending reductions, and that these reductions not only do not tend to harm economies but, rather tend to lead to economic growth.[24]

For instance, a recent extensive review of countries that faced perilously high debt levels, by Andrew Biggs, Kevin Hassett, and Matthew Jensen, considered the experiences of 21 OECD countries over a 37 year period.[25] They find that countries that failed to successfully reduce their debt are more the rule than the exception—success appears to be achieved in approximately one-fifth of cases. On average, the typical *unsuccessful* country used a combination of 53 percent tax increases and 47 percent spending cuts. By contrast, the typical *successful* country used, on average, 85 percent spending cuts. The authors conclude that "…fiscal consolidations based upon expenditure cuts have tended to be more effective than tax-based consolidations based on the evidence from empirical studies."

Spending Reductions And Economic Health

While immediate spending reductions slow the growth of our debt, they also have an economic impact. Some, such as the former Chair of President Obama's Council of Economic Advisors, Christina Romer, have said this impact is negative and could hurt a fragile economy. Others, such as Stanford economist and former Treasury official John Taylor argue that spending cuts can be beneficial to the economy.

The empirical evidence shows that spending cuts are more likely to help, rather than hurt, economic growth and job creation. Goldman Sachs analysts Ben Broadbent and Kevin Daly report in a cross-national study of fiscal reforms, for example, that: "In a review of every major fiscal correction in the OECD since 1975, we find that decisive budgetary adjustments that have focused on reducing government expenditure have (i) been successful in correcting fiscal imbalances; (ii) typically *boosted* growth; and (iii) resulted in significant bond and equity market outperformance. Tax-driven

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[24] Evidence that successful fiscal consolidation relies overwhelmingly on spending cuts rather than tax hikes can be found throughout the economics literature, including the following non-exhaustive list of research papers: Alberto Alesina and Silvia Ardagna (2010 paper in *Tax Policy and the Economy, Vol. 24*); Alesina and Roberto Perotti (1995 paper in *Economic Policy*; 1996 *National Bureau of Economic Research Working Paper 5730*); Alesina and Ardagna (1998 paper in *Economic Policy; 2009 National Bureau of Economic Research Working Paper 15438*); Andrew Biggs, Kevin Hassett, and Matthew Jensen (2010 *American Enterprise Institute Economic Policy Working Paper 2010-04*); Ben Broadbent and Kevin Daly (2010 Goldman Sachs *Global Economics Paper No: 195*); Francesco Giavazzi and Marco Pagano (1990 *National Bureau of Economic Research Macroeconomics Annual;* 1996 *National Bureau of Economic Research Working Paper 5332*); John McDermott and Robert Westcott (1996 paper in *Staff Papers-International Monetary Fund Vol. 43*); Roberto Perotti (1996 paper in *American Economic Review Vol. 86;* 1999 paper in *The Quarterly Journal of Economics Vol. 114*); Jürgen vonHagen and Rolf Strauch (2001 paper in *Public Choice Vol. 109*); Andrea Zaghini (1999 paper in *Banca Italia – Servizio di Studi Papers*); Organization for Economic Co-operation and Development's *OECD Economic Outlook 2007*; International Monetary Fund's 2010 *World Economic Outlook: Recovery, Risk, and Rebalancing.* Results in these and other studies give strong evidence that countries that have achieved the best results in extricating themselves from fiscal crisis relied much more heavily on spending cuts than tax increases, without necessarily experiencing downturns.

[25] Biggs, Hassett, and Jensen, *Historical Consolidations That Worked,* Economics Policy Working Paper 2010-04 (American Enterprise Institute, December 27, 2010) available at http://www.aei.org/docLib/20101227-Econ-WP-2010-04.pdf.

fiscal adjustments, by contrast, typically fail to correct fiscal imbalances and are damaging for growth."[26] [emphasis is original]

Several other studies support this finding. According to Harvard economist Alberto Alesina, drawing from his and other research on large fiscal adjustments across countries: "Spending cuts are much more effective than tax increases in stabilizing the debt and avoiding economic downturns. In fact, in several episodes, spending cuts adopted to reduce deficits have been associated with economic expansions rather than recessions."[27]

Professor Alesina, an expert on fiscal consolidation, concludes from his extensive cross-country empirical research that "[f]iscal adjustments based upon spending cuts are those with, by far, the highest chance of success."[28]

The message from the large body of cross-country evidence on fiscal consolidations and disincentive effects of higher taxes is clear: higher marginal tax rates lead to fewer jobs and less productive investment, while addressing the U.S.' looming debt crisis exclusively through spending cuts will provide the highest probability of success in reducing deficits and debt without imperiling economic growth.

In addition, the composition of the spending cuts has been shown to matter. For example, the 2007 OECD Economic Outlook states that: "A greater weight on cuts in social spending tended to increase the chances of success. A reason for this could be that governments more committed to achieving fiscal sustainability may also be more likely to reform politically sensitive areas. As a by-product of doing so, they may at the same time bolster the credibility of the consolidation strategy, thereby improving its chances of success."

The idea that cutting government spending helps economies and job creation would appear to run counter to many economic models that show spending cuts will reduce output and, therefore, slow the economy. There may be at least three reasons the empirical results do not fit the theory reflected in some economic models:

1. ***Effects from Reducing Uncertainty***—Debt reduction through spending cuts reduces the risk of, and uncertainty surrounding, future interest rate spikes. Greater certainty broadly and significantly benefits the economy. Reductions in uncertainty can unleash a large amount of resources that businesses, households, and banks invest in very short-term, liquid assets "just in case." There is reason to believe that a high degree of existing uncertainty—about future health care costs, energy costs, future costs of borrowing, and about regulations—is generating the strong preference for liquid investment over longer-term private investment in more illiquid productive assets. Those

[26] Ben Broadbent and Kevin Daly, *Limiting the Fall-Out from Fiscal Adjustment*, Global Economics Paper No: 195 (Goldman Sachs Global Economics, Commodities and Strategy Research, April 14, 2010) available at http://www2.goldmansachs.com/ideas/global-economic-outlook/limiting-the-fallout-doc.pdf.

[27] Alberto Alesina, *Fiscal adjustments: lessons from recent history,* Paper prepared for the Ecofin meeting in Madrid (Harvard University, April, 2010) available at http://www.economics.harvard.edu/faculty/alesina/files/Fiscal%2BAdjustments_lessons.pdf

[28] Ibid.

longer-term investments in things like factories and new business ventures are the much-needed fuel for job creation.[29]

2. ***Interest Rate Effects***—Reductions in national debt due to decreased spending will lead to lower interest rates which, in turn, will cause interest-sensitive private investment and consumption to receive a boost. Such a reverse case of the "crowding out" identified earlier occurs because lower interest rates make potential investment projects facing private businesses and households relatively more profitable to undertake. Lower interest rates means that less government borrowing of resources in markets lowers the interest cost of borrowing those resources to private businesses and households, thereby "crowding in" private interest-sensitive spending.[30]

   Lower interest rates can also be accompanied by appreciation of stocks and bonds, increasing financial wealth, and triggering even more accompanying increases in consumption and investment.

3. ***Wealth effects***—As households and businesses perceive that spending cuts are real and lasting, they become confident that they will not face higher taxes they would have otherwise faced in the future. The change in their perceived wealth stimulates higher consumption and investment including greater investments in labor, which leads to higher employment.

   Federal Reserve Chairman Bernanke, in a speech late last year, summarizes the potential for a country's fiscal position to have wealth effects by influencing expectations as follows:

   > Expectations of large and increasing deficits in the future could inhibit current household and business spending—for example, by reducing confidence in the longer-term prospects for the economy or by increasing uncertainty about future tax burdens and government spending—and thus restrain the recovery… Accordingly, steps taken today to improve the country's longer-term fiscal position would not only help secure longer-term economic and financial stability, they could also improve the near-term economic outlook.[31]

Conclusion

Having received numerous warnings from a variety of sources, the U.S. can no longer kick its fiscal problems further down the road. Given the recent debt-outlook downgrade from Standard & Poor's, the U.S. faces a loss of its top-tier credit rating if it waits to constrain growing deficits. The economy

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[29] Comments in minutes of many meetings over the past two years of the Federal Reserve's monetary policymaking Federal Open Market Committee (FOMC) identify business contacts citing uncertainties about taxes and regulations as restraining factors in hiring and investing. For example, in the minutes of the Committee's meeting on November 2-3, 2010, the FOMC writes that "Participants variously noted a number of factors that were restraining growth, including… continuing uncertainty about the future tax and regulatory environment…" Those minutes are available at http://www.federalreserve.gov/monetarypolicy/files/fomcminutes20101103.pdf.

[30] Stanford economist John Taylor writes, relative to older Keynesian models that show large "multiplier" effects through which changes in government spending have relatively large economic effects, that "[r]esearch by me and my colleague John Cogan finds that more up-to-date theories, which bring important incentive and expectations effects into account, show far smaller multipliers. In these models a reduction in the growth of spending will immediately *crowd in* private investment." [emphasis is original]. See http://johnbtaylorsblog.blogspot.com/2011/02/goldman-sachs-wrong-about-impact-of.html.

[31] See the text of Bernanke's speech at http://www.federalreserve.gov/newsevents/speech/bernanke20101004a.htm.

will suffer dearly if financial markets and our creditors lose faith in the Federal Government's commitment to paying off its obligations in full. Fearing default either explicitly or through inflationary policies, financial markets will demand ever increasing compensation for the risk through higher and higher interest rates. The resulting increased interest payments will choke off the ability of government to operate and will choke off private, interest-sensitive spending. The economy will be harmed, perhaps precipitously.

The U.S. can avoid catastrophe by curtailing spending immediately, and this need not threaten expansion of our private economy. Indeed, a large and growing body of empirical research identifies positive effects on economic growth from fiscal consolidations that relied primarily on spending cuts rather than tax hikes.

The nation faces stark and critical decisions about the size of government it desires. As experiences in many European countries have shown, high levels of government spending have negative economic effects, including persistently high unemployment rates.[32] Government spending in the United States over the past two years has exploded. Recent levels of spending, if locked in and financed by increased taxes, will severely inhibit the very economic growth necessary for the nation to pay down its unsustainably high levels of debt. Without bringing spending down toward historic norms, we face an unnecessarily weaker economic future.

In contrast, by reducing expenditures the U.S. can decide to strengthen incentives to invest in labor and capital, harness the productive potential of the strong American workforce, and ensure for our children that the United States will still have the most dynamic, productive, and resilient economy in the world.

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[32] The academic research by Nobel Prize-winning economist Edward Prescott, cited earlier, provides empirical evidence of negative economic effects stemming from high taxes used to support an expanded government sector. See also Daniel Mitchell, *The Impact of Government Spending on Economic Growth*, Backgrounder #1831 on the Federal Budget (The Heritage Foundation, March, 2005) available at http://www.heritage.org/Research/Reports/2005/03/The-Impact-of-Government-Spending-on-Economic-Growth.